CASE NOTES

TAXATION - A TAXPAYER MUST INCLUDE THE TOTAL NONRECOURSE OBLIGATION ON ENCUMBERED PROPERTY IN AMOUNT REALIZED UPON DISPOSITION OF PROPERTY AND THE FAIR MARKET VALUE OF THE PROPERTY IS IRRELEVANT TO THAT CALCULATION.—*Commissioner v. Tufts* (U.S. Sup. Ct. 1983)

Clark Pelt, entered into a general partnership agreement on August 1, 1970 with Clark, Inc.[1] for the purpose of constructing an apartment complex.[2] Financing for the project was arranged six days later when a mortgage loan agreement was negotiated.[3] A note and a deed of trust were executed by the partnership in the mortgagee's favor, in return for a loan of $1,851,500.[4] The loan was of a nonrecourse nature which precluded the partnership and its partners from incurring any personal liability.[5] Additional general partners were admitted later including respondent Tufts.[6]

The apartment complex was completed by August, 1971.[7] None of the partners made a capital contribution upon entering the partnership.[8] Total capital contributions from partners totalled $44,212 in 1971 and 1972.[9] Deductions by the partners for ordinary losses and depreciation during the same time period totaled $439,972.[10] In August of 1972, the adjusted basis for the complex was $1,455,740 after adding capital contributions and subtracting deductions.[11]

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1. Commissioner v. Tufts, 103 S. Ct. 1826, 1828 (1983). Clark, Inc., was wholly owned by Clark Pelt. *Id.*
2. *Id.* The 120 unit apartment complex was constructed in Duncanville, Texas, a suburb of Dallas. *Id.*
3. *Id.* The mortgagor was Farm and Home Savings Association. *Id.*
4. *Id.*
5. *Id.* A nonrecourse loan is a type of security loan which bars the lender from action against the borrower if the security value falls below the amount required to repay the loan. BLACK'S LAW DICTIONARY 953 (5th ed. 1979).
6. Commissioner v. Tufts, 103 S. Ct. at 1828. There are four general partners admitted: Tufts, Steger, Stephens and Austin. *Id.* All four were friends or relatives of Clark Pelt. *Id.*
7. *Id.*
8. *Id.*
9. *Id.* at 1828-29. In 1971 all partners made a contribution but in 1972 the only capital contribution was from Pelt. *Id.*
10. *Id.* at 1829.
11. *Id.* The original cost of the property was the amount of the loan.

+ Original Cost in 1970	1,851,500
+ Capital Contributions in 1971 and 1972	+ 44,212

Hard economic times reduced the expected income from the apartment complex and resulted in the partnership's failure to make payments to the mortgagee.[12] On August 28, 1972 the individual partners sold their interest in the partnership to Fred Bayles.[13] In addition to assuming the nonrecourse mortgage, Bayles agreed to pay sale expenses as consideration for the apartment complex.[14]

Each partner recorded a partnership loss of $55,740 on the theory that the fair market value of $1,400,000 limited the amount of the nonrecourse obligation realized.[15] During an audit, the Commissioner of Internal Revenue disagreed that fair market value limited the amount realized on nonrecourse debt.[16] His theory that amount realized included the nonrecourse debt, resulted in a gain on the sale of the apartment complex of $395,760.[17]

The United States Tax Court upheld the Commissioner's decision.[18] The Court of Appeals for the Fifth Circuit reversed, holding that fair market value of property does limit the amount of a nonrecourse obligation to be included in amount realized upon disposition of property.[19] The Fifth Circuit relied primarily on footnote 37 of *Crane v. Commissioner*[20] in its decision. In so deciding the Fifth Circuit expressly disagreed with the position taken by the Third Circuit.[21] The United States Supreme Court granted certiorari to resolve the conflict between circuits and *held*, reversed.[22] A taxpayer must include the total nonrecourse obligation of en-

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− Income tax deductions in 1971 and 1972	− 439,972
Equals Adjusted Basis in 1972	1,455,740

Id.

12. *Id.* A number of workers from Duncanville were laid off by the area's major employers leading to less than expected occupancy. *Id.*

13. *Id.* Fred Bayles, the purchaser of the apartment complex, was an unrelated third party. *Id.*

14. *Id.* Bayles agreed to pay up to $250 in sale expense to each general partner. *Id.*

15. *Id.* Adjusted basis in 1972

Adjusted basis in 1972	1,455,740
− Fair Market Value of Property	− 1,400,000
Equals loss per Tuft's theory	55,740

Id.

16. *Id.*

17. *Id.* Total Nonrecourse Loan

Total Nonrecourse Loan	1,851,500
− Adjusted Basis	− 1,455,740
+ Equals Gain per Commissioner	395,760

Id. at 1829 n.2.

18. *Id.* at 1829. *See* 70 T.C. 756 (1978). The tax court relied on Millar v. Commissioner, 577 F.2d 212, 215 (3rd Cir.), *cert. denied*, 439 U.S. 1046 (1978). Commissioner v. Tufts, 103 S. Ct. at 1829.

19. Commissioner v. Tufts, 103 S. Ct. at 1829.

20. Crane v. Commissioner, 331 U.S. 1, 14 (1947).

21. Commissioner v. Tufts, 103 S. Ct. at 1829. In *Millar v. Commissioner*, 577 F.2d at 212, the court found that fair market value of less than amount due on nonrecourse debt does not limit the amount of nonrecourse debt to be included in amount realized.

22. Commissioner v. Tufts, 103 S. Ct. at 1836. Justice Blackman delivered the opinion for a unanimous court. *Id.* at 1828. Justice O'Connor filed a concurring opinion. *Id.* at 1836.

cumbered property in amount realized upon disposition of property and the fair market value of the property is irrelevant to that calculation. *Commissioner v. Tufts,* 103 S. Ct. 1826 (1983).

The *Tufts* Court was faced with a question that had been left unanswered in the thirty-five years since the Court's landmark decision in *Crane v. Commissioner.*[23] *Crane* stands for the proposition that nonrecourse debt must be included in amount realized.[24] The Supreme Court had not provided guidance as to the handling of nonrecourse debt where there was no additional boot and in fact, where the fair market value was less than nonrecourse debt.[25] The position on treatment of nonrecourse obligation embraced by the Fifth Circuit would have provided large tax benefits to the holders of burnt out tax shelters financed with nonrecourse obligations.[26] The conflict between the circuit courts of appeal had to be resolved by the Supreme Court to provide nationwide unity in the interpretation of the Internal Revenue Code.[27]

The Court began its analysis by reviewing the decision in *Crane.*[28] In January of 1932, Beaulah Crane's husband died and she was the only beneficiary and executrix of her husband's will.[29] The assets of the estate included an apartment building and lot encumbered by a nonrecourse loan of $255,000 with interest of $7,042.50 in default.[30] The fair market value of the property was appraised to be equal to the loan.[31] Crane was not personally liable on the mortgage[32] but she continued to operate the property for nearly seven years.[33]

By then the interest in default had increased to $15,857.71 and Crane sold the property to avoid threatened foreclosure by the mortgagee.[34] Crane received $3,000 in cash and paid $500 in sale expenses.[35] On the theory that

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23. Crane v. Commissioner, 331 U.S. at 1.

24. Commissioner v. Tufts, 103 S. Ct. at 1828.

25. *Id.*

26. Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981). In footnote 9, the court recognized "that taxpayers will be able to use nonrecourse financing to inflate their basis in order to enjoy the benefit of large tax deductions that bear no relationship to actual economic loss." *Id.* at 1064 n.9. The court goes on to suggest that the best solution to the problem of a taxpayer's ability to manipulate basis in this manner is to "deal directly with the definitions of 'basis' and 'adjusted basis' either judicially or through legislation." *Id.*

27. Commissioner v. Tufts, 103 S. Ct. at 1829.

28. *Id.*

29. Crane v. Commissioner, 331 U.S. at 3.

30. *Id.*

31. *Id.*

32. *Id.* at 3-4.

33. *Id.* at 3. The agreement Crane entered into with the mortgagee provided that she: collect the rent, pay repair and operating expenses, reserve a monthly amount for taxes and remit net rentals to the mortgagee. *Id.*

34. *Id.*

35. *Id.*

her basis in the property was zero when she acquired it and the gain was the increased value upon sale,[36] Crane reported a gain of $2,500.[37] Crane's theory was inconsistent with her practice of deducting depreciation calculated not on a zero basis but upon a basis which included the nonrecourse mortgage.[38]

The Internal Revenue Commissioner found Crane's basis in the property to be the fair market value at her husband's death less depreciation.[39] He determined that the amount Crane realized on the sale was net cash[40] plus the amount of the outstanding nonrecourse mortgage.[41] By the Commissioner's calculations, Crane had realized net taxable gain of $23,767.03.[42] The Supreme Court upheld the Commissioner's interpretation[43] of Crane's basis[44] in the property.[45] Effectively the Court's ruling held "[t]hat the taxpayer's basis was the value of the property undiminished by the mortgage."[46]

The *Crane* Court next proceeded to affirm the Commissioner's interpretation of amount realized[47] under I.R.C. section 111(b).[48] The Court con-

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36. *Id.*

37. *Id.* Cash of $3,000 was received less the sale expenses of $500 result in a net gain of $2,500. *Id.*

38. *Id.* at 3 n.2.

39. *Id.* at 4. The Commissioner's assertions were based on I.R.C. §113(a)(5) (1938). Id. at 6-11. The current code provision is I.R.C. § 1014(a)(1) (West 1982) which is substantially similar and provides:

> (a) In general.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged or otherwise disposed of before the decedent's death by such person by (1) the fair market value of the property at the date of the decedent's death. . .

40. Crane v. Commissioner. 331 U.S. at 4. The purchaser paid Crane $3000 but she deducted expenses of $500 from the sale to get net cash received of $2500. *Id.* at 3-4.

41. *Id.* at 4. Determination of Amount Realized:

Principal due on Nonrecourse Mortgage	$255,000
+ Net Cash Received	2,500
Equals Amount Realized on Sale	$257,500

Id.

42. *Id.*

43. *Id.*

44. *See supra* note 39 and accompanying text.

45. Commissioner v. Tufts, 103 S. Ct. at 1830 (discussing Crane v. Commissioner, 331 U.S. at 9-10). "[T]he Court observed that to regard merely the taxpayer's equity in the property as her basis would lead to depreciation deductions less than the actual physical deterioration of the property, and would require the basis to be recomputed with each basis of the mortgage." *Id.* Crane v. Commissioner, 331 U.S. at 9-10.

46. Commissioner v. Tufts, 103 S. Ct. at 1830 (discussing Crane v. Commissioner, 331 U.S. at 11).

47. Crane v. Commissioner, 331 U.S. at 12-14.

48. I.R.C. § 111(b) (1938). The current provision is I.R.C. § 1001(b) (West 1982) which is substantially the same and provides:

> (b) Amount realized.—The amount realized from the sale or other disposition of

cluded that the nonrecourse mortgage had to be included in both amount realized and the taxpayer's basis.[49] "To do otherwise would have permitted Crane to recognize a tax loss unconnected with any actual economic loss."[50] The Court refused to construe one section of the code so as "to defeat the intention of another or to frustrate the Act as a whole."[51] The Court thus avoided the "absurdity" that would result from Crane accepting $2,500 on property worth over $250,000 and having a "99 percent loss."[52]

The Court disagreed with Crane's contention that nonrecourse obligations were entitled to different treatment merely because she had not assumed personal liability.[53] Crane's contentions were disposed of summarily for two reasons. First, separate treatment of recourse and nonrecourse mortgages to determine taxpayer basis and amount realized would result in the "absurdity" of Crane realizing $2500 on the sale of property worth $250,000 as well as "frustration" of the Act by allowing a tax loss unrelated to any economic loss (i.e., if nonrecourse debt was included in basis but not in amount realized).[54] Second, the Court applied what has become known as the "economic benefit theory."[55] Although not personally liable, it would be in the taxpayer's best interest to treat a mortgage as his own personal liability whenever the property is worth more than the amount of the mortgage.[56] Relying on this premise "if he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another."[57] Thus

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property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized-

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are paid by the purchaser.

49. Crane v. Commissioner, 331 U.S. at 13.

50. Commissioner v. Tufts, 103 S. Ct. at 1830.

51. Crane v. Commissioner, 331 U.S. at 13. *See also* Brons Hotels, Inc., 34 B.T.A. 376, 381 (1936).

52. Crane v. Commissioner, 331 U.S. at 13. "Petitioner conceded that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the 'amount realized' within the meaning of section 111(b)." *Id. See supra* note 47 and accompanying text.

53. Crane v. Commissioner, 331 U.S. at 4.

54. *Id.* at 13-14.

55. Commissioner v. Tufts, 103 S. Ct. at 1830; Del Cotto, *Basis and Amount Realized Under Crane: A Current View of Some Tax Effects in Mortgage Financing*, 118 U. Pa. L. Rev. 69, 83-84 (1969) [hereinafter cited as Del Cotto]; Comment, *Non-Recourse Liabilities: A Tax Shelter*, 29 Baylor L. Rev. 57, 73 (1977); Comment, *Tufts - The Resurrection of Crane's Footnote 37*, 9 Fla. St. U.L. Rev. 575, 579-580 (1981).

56. Crane v. Commissioner, 331 U.S. at 14.

57. *Id.*

under the economic benefit theory, Crane benefited as if she had received payment of the mortgage as well as the $2,500 boot.[58] Ultimately the Supreme Court in *Tufts* recognized that while the economic benefit theory applied to the facts in *Crane,* the conclusion in that case did not rely on that theory.[59]

It was at this point in the analysis of *Crane* that the Court inserted the infamous footnote 37[60] which has been referred to as "the most famous footnote in tax history."[61] Footnote 37 has led a controversial existence since *Crane* was handed down. It has been construed to be dictum,[62] to be a hypothetical[63] and to be a limitation on *Crane.*[64] In footnote 37 the Court observed

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.[65]

After reviewing the *Crane* decision, the *Tufts* Court did not perceive footnote 37 to limit *Crane* to its facts.[66] The Court cited *Crane* for the broad proposition that recourse and nonrecourse debt are to receive the same treatment.[67] Under I.R.C. section 1012,[68] a loan to purchase property is included in the taxpayer's basis for that property due to the taxpayer's obligation to repay.[69] "Because no difference between recourse and nonrecourse obligations is recognized in calculating basis, *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property."[70] The Court recognized that the Commissioner could have chosen a different method for the treatment of nonrecourse obligation.[71] However, so long as

58. *Id.*

59. Commissioner v. Tufts, 103 S. Ct. at 1834.

60. Crane v. Commissioner, 331 U.S. at 14, n.37.

61. Bittker, *Tax Shelters, Nonrecourse Debt and the Crane Case,* 33 TAX L. REV. 277 (1978) [hereinafter cited as Bittker].

62. Millar v. Commissioner, 577 F.2d at 215; Comment, *Non-Recourse Liabilities: A Tax Shelter,* 29 BAYLOR L. REV. 57, 73 (1977).

63. Millar v. Commissioner, 577 F.2d at 215; Del Cotto, *supra* note 54, at 83-85.

64. Tufts v. Commissioner, 651 F.2d at 1063.

65. Crane v. Commissioner, 331 U.S. at 14 n.37.

66. Commissioner v. Tufts, 103 S. Ct. at 1834.

67. *Id.*

68. I.R.C. § 1012 (West 1982). "The basis of property shall be the cost of such property . . ." *Id.* "In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property." Treas. Reg. § 1.1012-1 (1976).

69. Commissioner v. Tufts, 103 S. Ct. at 1834.

70. *Id.* at 1832.

71. *Id.* at 1831-32. One possible approach would be the theory" implicit in Crane's contentions, that a nonrecourse mortgage is not a true debt, but, instead is a form of joint invest-

recourse and nonrecourse obligations are treated the same "[t]hat the amount of the loan exceeds the fair market value of the property thus becomes irrelevant."[72]

The amount realized under I.R.C. section 1001 (b)[73] would thus include ". . . the amount of the nonrecourse mortgage assumed by the purchaser."[74] The Court gives the following rationale to support the inclusion of nonrecourse debt in amount realized.[75] The assumption originally made when the mortgage was included in the taxpayer's basis is applicable: there is an obligation that the mortgagor has agreed to repay.[76] The proceeds of the loan are not included in income nor will there be a tax liability upon repayment of the loan.[77] The inclusion of nonrecourse mortgage in amount realized balances with its inclusion in taxpayer's basis.[78] "Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property."[79] The Court found that the Commissioner's interpretation of I.R.C. section 1001(b)[80] to include the amount of nonrecourse obligations in amount realized was not unreasonable.[81]

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ment by the mortgagor and mortgagee." *Id.* at 1831 n.5. If this theory was adopted the taxpayer would have a zero basis upon receipt of the nonrecourse debt that would gradually increase as the nonrecourse obligation was paid. *Id.* Lurie, *Mortgagor's Gain on Mortgaging Property for More than Cost Without Personal Liability*, 6 TAX L. REV. 319, 323 (1951); Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1514 (1982).

The Court does not decide which approach would "be preferred if *Crane* were not on the books." Commissioner v. Tufts, 103 S. Ct. at 1831 n.5. The "resultant benefits to the taxpayer" of the Commissioner's decision to treat nonrecourse debt as a recourse debt has been to allow taxpayers who bear no risk to receive benefits from depreciation on the property. *Id. See* Bittker, *supra* note 60, at 283.

72. Commissioner v. Tufts, 103 S. Ct. at 1831.

73. I.R.C. § 1001(b) (West 1982). *See supra* note 47 and accompanying text.

74. Commissioner v. Tufts, 103 S. Ct. at 1832.

75. *Id.* at 1831-34.

76. *Id.* at 1831.

77. *Id.*

78. *Id.*

> When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not quality as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.

Id.

79. *Id.* at 1832.

80. I.R.C. § 1001(b) (West 1982). *See supra* note 47 and accompanying text.

81. Commissioner v. Tufts, 103 S. Ct. at 1832. "Congress has delegated to the Commissioner, not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code." United States v. Correll, 389 U.S. 299, 307 (1967) (quoting I.R.C. section 7805 (a)). "The choice among reasonable interpretations is for the Commissioner not the courts." Natl. Muffler Dealer's Ass'n. v. United States, 440 U.S. 472, 488 (1979). *See also* United States v. Correll, 389 U.S. 299 (1967) (The Court found that the Com-

The Court noted that the Commissioner has been applying this rule[82] "even where the fair market value of the property falls below the amount of the nonrecourse obligation."[83] The permissability of this treatment is no longer questioned by the Court after *Crane's* holding that recourse and nonrecourse debt will be treated the same.[84]

Respondents argued that Congress has legislated an exception in I.R.C. section 752(c)[85] which allows the proceeds of a nonrecourse loan to be included in basis but not in amount realized upon sale or disposition of partnership property.[86] I.R.C. section 752 addresses treatment of certain liabilities of a partnership.[87] Section 752(a) and (b) addresses the increase or decrease of liabilities in transactions between a partner and his partnership and the partner's resulting adjusted basis.[88] Section 752(c) provides that "for purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property."[89]

The Court acknowledged that "[s]ection 752(c) could be read to apply to a sale or disposition of partnership property, and thus to limit the amount realized to the fair market value of the property transferred."[90] However, the Court found I.R.C. section 752(d) to be inconsistent with that

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missioner could deny a traveling salesman deductions for breakfast and lunch because his daily trips required neither sleep nor rest on the basis that the "neither sleep nor rest" test was a reasonable exercise of the Commissioner's power.)

82. *See* Treas. Reg. § 1.1001-2(b) (1982). This regulation came down while *Tufts* was pending before the Court of Appeals for the Fifth Circuit. Commissioner v. Tufts, 103 S. Ct. at 1833 n.9. It only formalized the Commissioner's earlier interpretations. *Id. See* Rev. Rul. 111, 1976-1 C.B. 214.

83. Commissioner v. Tufts, 103 S. Ct. at 1832.

84. *Id.* at 1833.

85. I.R.C. § 752 (West 1982).

(a) Increase in partner's liabilities.—Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Decrease in partner's liabilities.—Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) Liability to which property is subject.—For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) Sale or exchange of an interest.—In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

86. Commissioner v. Tufts, 103 S. Ct. at 1834.

87. *Id.* at 1835. *See supra* note 83 and accompanying text.

88. *See supra* note 83 and accompanying text.

89. *Id.*

90. Commissioner v. Tufts, 103 S. Ct. at 1835.

interpretation.[91] Section 752(d) provides that "in case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."[92] The Court relies on legislative history[93] to support its determination that I.R.C. section 752(c) is a limitation on I.R.C. section 752(a) and (b)[94] but does not "limit the amount realized in a sale or

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91. *Id.*

92. *See supra* note 83 and accompanying text.

93. The legislative history for the House Report states as follows:

> § 752. Treatment of certain liabilities. Frequently, a partner will assume partnership liabilities or a partnership will assume a partner's liabilities. In some cases this occurs as the result of a contribution of encumbered property by the partner to the partnership. The provisions of this section prescribe the treatment for such transferred liabilities. Whenever a partner's individual liabilities are increased because of the assumption by him of partnership liabilities, the amount of the increase shall be treated as a contribution of money by the partner to the partnership. Similarly, when the liabilities of the partnership are increased, thereby increasing each partner's share of such liabilities, the amount of the increase shall be treated as a pro rata contribution by the partners, thereby raising the basis of each partner's interest in the amount of his share of the increase.
>
> Conversely, when a partner's personal liabilities are decreased because a portion of them have been assumed by the partnership the amount of the decrease shall be treated as a distribution of money by the partnership to the partner. Similarly, when the liabilities of the partnership are decreased, thereby decreasing each partner's share of such liabilities, the amount of the decrease shall be treated as a pro rata distribution by the partnership, thereby reducing the basis of each partner's interest in the amount of his share of the decrease.
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> The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property.
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> This section may be illustrated as follows:
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> If a partner contributes property with basis of $1,000, subject to a mortgage of $500, to a partnership in exchange for a one-half interest in the partnership, the basis of his interest will be $1,000 (the basis of the contributed property) reduced by $250 (the amount of his liability with respect to such property assumed by the other partner), or $750. The contributing partner still remains subject to $250 of his original $500 liability. When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied. Thus, if a partner sells his interest in a partnership for $750 cash and, at the same time, transfers to the purchaser his pro rata share of partnership liabilities amounting to $250, the amount realized by the seller on the transaction is $1,000, which will be applied against the basis of his interest in order to determine his gain or loss.

H.R. REP. No. 1337, 83d Cong., 2d Sess. A236, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4376-77.

The legislative history of the Senate Report is virtually identical to the House Report. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 405, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 5047-48.

94. Commissioner v. Tufts, 103 S. Ct. at 1835-36.

exchange of a partnership interest under section 752(d)."[95]

The Court's decision in *Tufts* resulted from conflicting treatments of nonrecourse debt between courts of appeal.[96] In *Millar v. Commissioner*[97] the basis in certain stock[98] was equal to taxpayer's costs, which was zero because the stock was given to them.[99] Nonrecourse[100] loans totalling $245,000[101] were received by taxpayers and were secured by the taxpayers' stock.[102] The total tax basis of the stock was $245,000.[103] The basis was reduced by interest deductions and net operating loss deductions totalling $205,508 which gave the stock an adjusted basis of $39,492.[104] At that point in time the nonrecourse loans were cancelled in return for the surrender of the stock.[105]

It was the Internal Revenue Commissioner's position[106] that taxpayers had received a net gain of $205,508.[107] The taxpayers contended that footnote 37 of the *Crane* opinion[108] created an exception to the general rule in *Crane* and prevented the Commissioner's interpretation.[109] The court in *Millar* upheld the Commissioner's interpretation of *Crane* that amount realized upon the surrender of the stock included the total nonrecourse obligation.[110] The analysis taken by the *Millar* court differs from that applied by the Supreme Court in *Tufts* although the results—inclusion of nonrecourse debt in amount realized—are the same.[111]

The court in *Millar* relied on the "spirit and reasoning of *Crane*" in

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95. *Id.* at 1836.
96. Commissioner v. Tufts, 103 S. Ct. at 1829.
97. Millar v. Commissioner, 577 F.2d at 212.
98. *Id.* at 213. The stock was in the Grant County Coal Corporation. *Id.*
99. I.R.C. § 1012 (West 1982). *See supra* note 67.
100. Millar v. Commissioner, 577 F.2d at 215. The stock was received from R. H. Jamison, Jr. *Id.*
101. *Id.*
102. *Id.* at 213.
103. *Id.* at 215 (citing 26 U.S.C. § 1016). *See infra* note 121.
104. Millar v. Commissioner, 577 F.2d at 215.

Calculation of Adjusted Basis:

Basis of Stock	245,000
− Interest Deductions and Net Operating Loss Deductions	205,508
= Adjusted Basis in Stock	39,492

105. *Id.*
106. *Id.* The Commissioner relied on I.R.C. § 1001(b) (West 1982). *See supra* note 46.
107. *Id.*

Total Nonrecourse Debt Cancelled	245,000
− Adjusted Basis in Stock	39,492
= Net Gain per Commissioner	205,508

Id.

108. *Id.* at 214. *See supra* note 60 and the accompanying text.
109. Millar v. Commissioner, 577 F.2d at 214.
110. *Id.* at 215.
111. Commissioner v. Tufts, 103 S. Ct. at 1833, n.10.

reaching their conclusion.[112] The court recognized that the taxpayers had received a tax benefit by utilizing nonrecourse obligations "to increase the basis of their stock, which then permitted them to claim sizeable deductions calculated against that basis."[113] The court also noted that taxpayers had realized the "full economic benefit of this transaction" and failure of the taxpayers to realize a gain would result in the same "type of double deductions of which the Supreme Court so clearly disapproved in *Crane*."[114]

The *Millar* court expressly refused a literal reading of footnote 37 as determinative in the case.[115] The court said the footnote had been dictum.[116] "Furthermore, the footnote was but a postulate or hypothetical set of facts not before the Court and . . . involving a clearly different time and clearly different legal circumstances."[117]

The *Millar* court's interpretation of footnote 37 was quite different than the Fifth Circuit's in *Tufts*.[118] In *Tufts* the lower court adopted a literal reading of footnote 37 to limit the amount that can be realized on property encumbered by nonrecourse mortgage to the fair market value of the property.[119] In support of this position the court rejects the "double deductions" theory in *Millar* as "the principal reason underlying *Crane*."[120] In justification of its position, the court interprets I.R.C. section 1001(a)[121] to provide " 'gain' from the sale or other disposition of property is computed by subtracting the 'adjusted basis' from the 'amount realized.' "[122] Adjusted basis

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112. Millar v. Commissioner, 577 F.2d at 215.

113. *Id.* Upon surrender of the devalued stock "in exchange for the cancellation of their indebtedness, the taxpayers clearly realized taxable gain equal to the value of the cancelled obligation, less the adjusted basis of their surrendered stock." *Id.*

114. *Id.*

115. *Id.* The court did not go so far as to say the footnote was of no value in the instant case but chose to evaluate it in its proper context. *Id.*

116. *Id.*

117. *Id.*

118. Tufts v. Commissioner, 651 F.2d at 1060.

119. *Id.*

120. *Id.* The court's analysis is based on the fact that before double deductions were mentioned in the Supreme Court's opinion, "it had already concluded that the Commissioner had properly determined the amount realized." *Id.* It is also pointed out that the Supreme Court didn't mention double deductions until the last paragraph of the *Crane* opinion which addressed the constitutional argument raised by Mrs. Crane. *Id.* Her argument had been that the nonrecourse obligation "was not income within the meaning of the sixteenth amendment." *Id.* Upon this analysis, the Fifth Circuit court in *Tufts* rejected double deductions as the principal justification for the Court's opinion in *Crane* that amount realized included nonrecourse debt. *Id.*

121. I.R.C. § 1001(a) (West 1982).

> (a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

122. Tufts v. Commissioner, 651 F.2d at 1061.

is determined pursuant to I.R.C. section 1016[123] by deducting depreciation and other costs against the property from basis in the property.[124] Therefore, the court states "any tax benefit that the taxpayer may have received in the form of prior deductions have already been factored into the gain equation through adjustment to basis."[125] The court observed that its conclusion was consistent with *Crane*.[126] The court concluded "that Congress chose to 'consider' and account for those allowable deductions [depreciation, depletion, etc.] through adjustments to basis, and not through an expansive definition of amount realized."[127]

In the *Tufts* decision, the Fifth Circuit's analysis was based on its belief

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123. I.R.C. § 1016 (West 1982 & Supp. 1983).

(a) General rule-Proper adjustment in respect of the property shall in all cases be made-

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made

(A) for taxes or other carrying charges described in section 266, or

(B) for expenditures described in section 173 (relating to circulation expenditures).

for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount-

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws, but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under section 167(b)(1). Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020 (as in effect before the date of the enactment of the Tax Reform Act of 1976). Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

124. Tufts v. Commissioner, 651 F.2d at 1061.

125. *Id.* "Since those deductions have been accounted for through adjustments to basis, it follows logically that they cannot also support an expansion of amount realized." *Id.* "To account for those deductions twice in the same equation by expanding the definition of amount realized as well as adjusting basis downward would, we think, be taxing the taxpayer twice on the same component of gain." *Id.*

126. *Id.* at 1061 n.5.

127. *Id.*

that the *Crane* decision was based on an economic benefit theory.[128] This theory is premised on the proposition that "when a debt on which a taxpayer is personally liable is discharged, the taxpayer is freed from the necessity of paying the obligation with cash or other assets equal in value to the principal amount of the debt."[129] In *Crane*, the Court stated as a reality that where the taxpayer is not personally liable but the property is mortgaged at less than the fair market value of the property, there is incentive for the taxpayer to treat the obligations as though he were personally liable.[130] The *Tufts* court believes this extension of the economic benefit theory is flawed[131] in "that it rings true only so long as the taxpayer actually wants to keep the property."[132]

In *Tufts*, the Fifth Circuit expressly disagreed with the Third Circuit decision in *Millar*.[133] The Court declined to extend *Crane* "beyond the facts of that case" and recognize footnote 37 of *Crane* as a fair market value limitation on amount realized upon disposition.[134] The Supreme Court granted certiorari in order to resolve the conflict in the courts of appeal.[135]

The Supreme Court in its ruling in *Tufts* has provided guidance to the Tax Courts and Courts of Appeal on the issue raised in *Crane* thirty-five years ago. Even where fair market value is less than the amount of nonrecourse mortgages the entire mortgage outstanding must be included in amount realized on sale or disposition of that property.

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128. *Id.* at 1061.

129. *Id.*

130. *Id.* at 1062. Crane v. Commissioner, 331 U.S. at 14.

> Or put in another way, we are no more concerned with whether the mortgagor is, strickly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strickly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

Id.

131. Tufts v. Commissioner, 651 F.2d at 1062.

132. *Id.* In support of its position that the economic benefit theory is flawed, the court quotes the following from Bittker, *Tax Shelters, Nonrecourse Debt and the Crane Case*, 33 TAX. L. REV. 277, 282 (1978):

> Relief from a nonrecourse debt is not an economic benefit if it can be obtained only by giving up the mortgaged property. It is analogous to the relief one obtains from local property taxes by disposing of the property. Like nonrecourse debt, the taxes must be paid to retain the property; but no one would suggest that the disposition of unprofitable property produces an economic benefit equal to the present value of the taxes that will not be paid in the future.

133. Commissioner v. Tufts, 103 S. Ct. at 1829.

134. Tufts v. Commissioner, 651 F.2d at 1063.

135. Commissioner v. Tufts, 103 S. Ct. at 1829. Certiorari was granted in Commissioner v. Tufts, 456 U.S. 960 (1982).

The Court did recognize one situation in which the total nonrecourse debt might not be included in amount realized.[136] The Court implied that its holding in *Tufts* may have been different if taxpayers received proceeds of less than "face value of their note."[137] The analysis the Court used in *Tufts* that *Crane* held nonrecourse and recourse mortgages are to be treated alike may surprise some commentators.[138] Those commentators have analyzed *Crane* in terms of an economic or tax benefit[139] theory.

The Court acknowledges that the economic theory did apply to "the specific circumstances of *Crane*" but this was secondary to *Crane's* proposition that nonrecourse mortgages are to be treated as though the mortgagor had assumed personal liability.[140] The Court explained that footnote 37 was designed to show the limitations of the economic benefit theory "when applied to a different set of facts."[141]

The long term effect of *Tufts* has been minimized because the Supreme Court has only formalized what the Commissioner and Tax Courts already believed to be the law. The Fifth Circuit[142] had raised a glimmer of hope for holders of burned out tax shelters who would have benefited from the fair market value limitation.[143] Congress has enacted I.R.C. section 465[144] which

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136. Commissioner v. Tufts, 103 S. Ct. at 1832, n.6.

137. *Id.*

138. *See supra* note 54 and accompanying text.

139. *Id.* "The rationale of the tax benefit theory is that since a taxpayer claims deductions computed upon basis including the nonrecourse mortgage, the amount realized upon disposition must include the amount of the mortgage." Comment, *Tufts - The Resurrection of Crane's Footnote 37*, 9 FLA. ST. U.L. REV. 575, 579 (1981).

140. Commissioner v. Tufts, 103 S. Ct. at 1834.

141. *Id.*

142. Tufts v. Commissioner, 651 F.2d 1058 (5th Cir. 1981).

143. Comment, *Tufts v. Commissioner: Crane's Footnote 37 Reviewed*, 34 BAYLOR L. REV. 675, 697-698 (1982); Comment, *Tufts—The Resurrection of Crane's Footnote 37*, 9 FLA. ST. U. L. REV. 575, 593-97 (1981).

144. I.R.C. § 465 (West 1978 & Supp. 1983).

(a) Limitation to amount at risk.—

(1) In general.—In the case of-

(A) an individual and

(B) a corporation with respect to which the stock ownership requirement of paragraph (2) of section 542(a) is met,

engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

(2) Deduction in succeeding year.-Any loss from an activity to which this section applies not allowed under this section for the taxable year shall be treated as a deduction allocable to such activity in the first succeeding taxable year.

(3) Special rules for applying paragraph (1)(B).—For purposes of paragraph (1)(B)-

(A) section 544(a)(2) shall be applied as if such section did not contain the phrase "or by or for his partner"; and

(B) section 544(a)(4)(A) and 544(b)(1) shall be applied by substituting "the corporation meet the stock ownership requirements of section 542(a)(2)" for "the corporation a personal holding company."

(b) Amounts considered at risk.—

(1) In general.-For purposes of this section, a taxpayer shall be considered at risk for an activity with respect to amounts including-

(A) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity, and

(B) amounts borrowed with respect to such activity (as determined under paragraph (2)).

(2) Borrowed amounts.-For purposes of this section, a taxpayer shall be considered a risk with respect to amounts borrowed for use in an activity to the extent that he-

(A) is personally liable for the repayment of such amounts, or

(B) has pledged property, other than property used in such activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).

No property shall be taken into account as security if such property is directly or indirectly financed by indebtedness which is secured by property described in paragraph (1).

(3) Certain borrowed amounts excluded.—For purposes of paragraph (1)(B), amounts borrowed shall not be considered to be at risk with respect to an activity if such amounts are borrowed from any person who-

(A) has an interest (other than an interest as a creditor) in such activity, or

(B) has a relationship to the taxpayer specified within any one of the paragraphs of section 267(b).

(4) Exception.-Notwithstanding any other provision of this section, a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.

(5) Amounts at risk in subsequent years.—If in any taxable year the taxpayer has a loss from an activity to which subsection (a) applies, the amount with respect to which a taxpayer is considered to be at risk (within the meaning of subsection (b)) in subsequent taxable years with respect to that activity shall be reduced by that portion of the loss which (after the application of subsection (a)) is allowable as a deduction.

(c) Activities to which section applies.

(1) Types of activities.—This section applies to any taxpayer engaged in the activity of-

(A) holding, producing, or distributing motion picture films or video tapes,

(B) farming (as defined in section 464(e)),

(C) leasing any section 1245 property (as defined in section 1245(a)(3)),

(D) exploring for, or exploiting, oil and gas resources as a trade or business or for the production of income, or

(E) exploring for, or exploiting, geothermal deposits (as defined in section 613(e)(3)).

(2) Separate activities.—For purposes of this section, a taxpayer's activity with respect to each-

(A) film or video tape,

limits taxpayer deductions for depreciation to the amount he has at risk[145] in certain investment activities.[146] Currently, investments in real estate are specifically excluded from the deduction limitation.[147] Although *Tufts* has resolved the issue raised thirty-five years ago in *Crane*, the final decision may lie in future legislation involving deduction limitations.

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(B) section 1245 property which is leased and held for leasing,
(C) farm,
(D) oil and gas property (as defined under section 614), or
(E) geothermal property (as determined under section 614)
shall be treated as a separate activity. A partner's interest in a partnership or a shareholder's interest in an S corporation shall be treated as a single activity to the extent that the partnership or the S corporation is engaged in activities described in any subparagraph of this paragraph.

(3) Extension to other activities.-

(A) In general.—In the case of taxable years beginning after December 31, 1978, this section also applies to each activity-

(i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and

(ii) which is not described in paragraph (1).

(B) Aggregation of activities where taxpayer actively participates in management of trade or business.—Except as provided in subparagraph (C), for purposes of this section, activities described in subparagraph (A) which constitute a trade or business shall be treated as one activity if-

(i) the taxpayer actively participates in the management of such trade or business, or

(ii) such trade or business is carried on by a partnership or an S corporation and 65 percent or more of the losses for the taxable year is allocable to persons who actively participate in the management of the trade or business.

(C) Aggregation or separation of activities under regulations.- The Secretary shall prescribe regulations under which activities described in subparagraph (A) shall be aggregated or treated as separate activities.

(D) Exclusions for real property.-In the case of activities described in subparagraph (A), the holding of real property (other than mineral property) shall be treated as a separate activity, and subsection (a) shall not apply to losses from such activity. For purposes of the preceeding sentence, personal property and services which are incidental to making real property available as living accommodations shall be treated as part of the activity of holding such real property.

(E) Application of subsection (b)(3).-

In the case of an activity described in subparagraph (A), subsection (b)(3) shall apply only to the extent provided in regulations prescribed by the Secretary.

145. I.R.C. § 465(a) (West Supp. 1983). *See supra* note 142 and accompanying text.

146. I.R.C. § 465(c) (West 1982 & Supp. 1983). *See supra* note 142 and accompanying text.

147. I.R.C. § 465(c)(3)(D) (West Supp. 1983). *See supra* note 142 and accompanying text.